

Agriculture and the 2008 Credit Crisis

The Intersection of Farm Credit and Farm Policy

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In the fall of 2008, a new farm bill was implemented while the financial and credit markets were in crisis. These two events interact, because farm program provisions have historically played a critical role in the ability and capacity of farmers to obtain credit.

The historical motivation for government intervention in agriculture comes from the social need to ensure an abundant and dependable supply of food and fiber. The United States has a long history of supporting agricultural production by supporting the farmer's profit capacity. It takes no leap of logic to see that agricultural lenders have an interest and stake in the underlying support provided to their borrowers. Insurance products, safety nets, and direct government support to farmers translate into guarantees, collateral, and reduced risk for agricultural lenders.

While Congress passed a bailout plan to re-establish the efficient flow of credit, markets remain extremely volatile; tighter credit,

higher interest rates, and higher credit standards are likely during the 2009 crop year. As we look forward to implementing a new farm bill and uncertain credit markets, it is useful to examine ways the new farm bill and the uncertain credit market may affect each other.

The Connection between Credit and Policy

The most direct connection between farm policy and credit are the programs that intend to ensure the availability of financing for farmers and ranchers. The USDA, through the Farm Service Agency (FSA), is the "lender of last resort" by providing direct loans to producers who can not obtain credit elsewhere. In addition, many loan programs provide financing and/or more affordable term financing to certain segments, such as young or beginning farmers. FSA also underwrites or guarantees farm and ranch loans, reducing the risk to commercial lenders and ensuring the availability of credit for agricultural production.

Traditional government commodity programs have also been instrumental in credit decisions. The loan rate program effectively creates a minimum price upon which a

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producer (and therefore his lender) can rely. In commodity markets where prices are uncertain, knowing the worst case scenario regarding the price a farmer will receive alleviates some of the credit risk in determining whether the farmer's operating note can be repaid. Similarly, the historical target price programs and the recent counter-cyclical payment program offer a source of added revenue to the farmer when prices fall, again reducing at least a portion of the lender's risk in financing crop production. In 1996, fixed direct payments were added to the policy tools to support production agriculture. Direct payments, which are certain well in advance, provide potential collateral for operating loans, thus reducing lender risk.

While crop insurance is not often considered in the context of farm bill provisions, the subsidized premiums for crop insurance have helped create a tool that might otherwise not be available to agriculture. Agricultural lenders have used crop insurance to further reduce loan default risk by requiring some borrowers to purchase at least a minimal level of crop insurance.

On the surface, it seems that most of the tools supporting agricultural production have the greatest effect on the credit risk of short-term operating loans. However, government support for agriculture also provides at least some level of comfort concerning the repayment capacity on intermediate-term loans for equipment and long-term loans for agricultural land.

Changing Commodity Markets

In addition to the recent derailing of the credit markets, significant losses on Wall Street, and declining domestic and global economies, agriculture has also experienced dramatic changes in commodity prices and production costs over the last few years. How will these changes, along with a new farm bill, interact with agricultural credit?

Although there has been some retreat recently, agricultural commodity prices have skyrocketed over the last several years. While cotton and peanut prices have remained in the neighborhood of traditional loan rate and target price levels, the food and feed grain complex has risen to record levels. At the same time, the push to plant more acres and rising energy costs have also raised the cost of production to record levels. Consider the following ballpark figures for corn. In 2006, it took around \$1.50 in variable expenses to produce a bushel of corn, and that bushel eventually fetched a handsome \$3.04 in the market. Now consider the credit relationship during that growing season. Many agricultural lenders would have loaned the operating money (about \$1.50 per bushel) knowing that the loan rate would ensure the producer at least \$1.95 per bushel. In 2009, the

same \$1.95 loan rate does not cover an expected variable cost in the range of \$2.50 per bushel. While most expectations are that the 2009 market will provide some return above the \$2.50 variable costs, when it comes to evaluating credit risk in today's environment, expectations provide no security.

Over the same 2006-2009 period, the variable cost of production for cotton has increased from about \$0.46 per pound to almost \$0.74 per pound. A cotton loan rate of \$0.52 per pound does not sufficiently secure an operating loan in the neighborhood of \$0.74 per pound. Additionally, the overall profit potential is very slim, calling into question the repayment capacity for longer term loans tied to cotton production. This environment, in conjunction with the smaller amount of loan money available in the financial markets, suggests that agricultural lenders should be looking more intently at their credit ratings, repayment capacity, and equity positions.

Potential Help from the 2008 Farm Bill?

While the levels of commodity loan rates and target prices for some crops seem to be less relevant, the 2008 farm bill has two new programs with the potential to re-establish some sense of certainty for agricultural operating loans, although the rules for both programs have not been determined and they may have less direct effect on credit risk.

The ACRE Program

The first is the Average Crop Revenue Election (ACRE) program, which makes payments to producers by crop and by farm when both state revenue and the individual farm revenue fall below specified trigger levels. The program has provisions for adjusting the trigger levels each year based on moving averages of commodity prices and revenue; therefore, it is designed to adjust to changing market and yield levels over time. That means the trigger or guarantee level of revenue has a good chance of being relevant compared to the level of operating money borrowed to produce a crop. Another benefit is the apparent flexibility to decide which crop to plant on ACRE-enrolled base acres each year. Production on land in excess of base acres will not be eligible. On the downside, the revenue protection is not a complete guarantee for the producer or lender. It is entirely possible for a producer to have a revenue shortfall relative to his own revenue trigger and receive no payments because the state revenue did not fall below the state trigger. The timing of ACRE payments may also detract from the program's ability to alleviate credit risk. The final calculation of revenue, and therefore any payment, is not possible until the end of the crop marketing year. By that time, a producer and lender are

well into the next year's crop and operating loan. It is important to note the ACRE payment benefit is capped at 25 percent of the ACRE revenue trigger level.

Signing up for the ACRE program has a cost. A producer must give up 20 percent of the direct payment, which many lenders have come to rely on as a source of collateral. Also, enrolling a farm in ACRE means accepting a 30 percent reduction in loan rates for that farm's production. These costs may be significant, not only in absolute value, but in the loss of improved credit risk that direct payments and loan rates provide.

The SURE Program

Another new provision of the 2008 farm bill is a permanent disaster program known as SURE (Supplemental Revenue Assistance Payments). Like ACRE, the idea of the SURE program is to provide benefits for losses in revenue. Intended for disaster situations, SURE covers a person's entire operating revenue rather than a single enterprise or farm. Essentially, a whole farm revenue guarantee is established at 115 percent of the implied guarantee of purchased crop insurance (using price and yield elections along with proven yields). The program requires the purchase of crop insurance and will make up 60 percent of the difference when actual farm revenue falls below the guarantee. Actual farm revenue in this case includes indemnities, crop value, 15 percent of direct payments, and all other government payments. Whether SURE will provide any security to a farm's operating line of credit is uncertain. While it does establish a disaster program that is formula driven rather than dependent on the passage of specific legislation for a disaster, it still requires that USDA declare a disaster in the county and benefits are limited, so larger farms would see less value. The newness and complexity of the program suggest it will take some time before SURE will have any significant impact on credit risk and perceived repayment capacity.

Other Considerations

Payments to individuals are limited in both ACRE and SURE. The structure of payment limits is changing, with the 2008 farm bill, to direct attribution to individuals; however, the overall level of limitation is similar (especially for married couples) to the past. To the extent that some producers' government program benefits may be more restricted, credit repayment capacity could be diminished. One potential change on the horizon could have longer term impacts on the future of farm program benefits. With ever-increasing federal budget deficits, it is reasonable to presume that budget reconciliation legislation may be debated in the coming years. The possibility of a reconciliation calling for spending cuts in the farm bill brings into question the longevity of program benefits at their current levels.

Credit Outlook

In 2009, the environment caused by tighter credit markets, volatile commodity prices, escalating agricultural production costs, and changing farm policies will cause agricultural lenders to be more cautious. Because some of the traditional farm policy provisions may provide less support for credit repayment and the 2008 farm bill provisions are untested in the eyes of lenders, credit is likely to be tighter in the coming year. In addition, some lenders may have no choice but to ration the limited supply of credit to which they have access in the financial markets. For the 2009 crop, expect lenders to ask more of their borrowers, both in the form of collateral and in solid production year plans that prove repayment capacity. Crop insurance (for example, Crop Revenue Coverage), although much more expensive with higher commodity prices, may be more important to credit than ever. Farm Service Agency loan guarantees may also be in greater demand. These guarantees usually require more time and paperwork, but they can protect a lender's balance sheet. So, the bottom line is to plan ahead, plan well, and start the conversation with your lender sooner rather than later.

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